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IN THE

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1967.

No. 1148.

WALTER E. HELLER AND COMPANY,
Petitioner,

vs.

CHARLES C. SHAW, Trustee in Bankruptcy for
Bemporad Carpet Mills, Inc.,
Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

I. THE PETITION IS NOT WITHIN THE SCOPE OF SUPREME COURT RULE 19.

The petition for a writ of certiorari should be denied, for the reason that the instant case does not come within the scope of Rule 19 of the Rules of the United States Supreme Court. The reason assigned in the Petition, namely: that there is a conflict between the circuit courts of appeal; is not supported by the record. Nor does the

case present any "special and important reasons" for a review on writ of certiorari, as required by Rule 19.

The case here involved is a simple preference action brought by a trustee in bankruptcy to recover certain voidable preferential transfers, pursuant to Sections 60 (a) and (b) of the Bankruptcy Act (11 U. S. C. A., § 96). The defense asserted is the right of set-off under Section 68 (a) of the Bankruptcy Act (11 U. S. C. A., § 108 (a)).

Both the claim asserted by the trustee and the defense interposed by Walter E. Heller & Co. involve the application of established principles of law, and neither issue requires clarification by the United States Supreme Court.

II. QUESTION PRESENTED.

Respondent is of the opinion that the question presented, as stated on page 2 of the Petition, is an oversimplification and is therefore inaccurate. The question is more properly stated as follows:

> "Where a factor, within the four month period prior to bankruptcy, receives certain accounts receivable from the bankrupt, for which the factor gives no present consideration but merely posts a credit balance in the factoring account, and thereafter the factor debits the aforementioned account to satisfy antecedent indebtedness that the bankrupt owes to the factor, can the factor avoid liability to the trustee in bankruptcy by invoking the defense of set-off when all of the elements of a voidable preferential transfer are present?"

III. STATEMENT OF THE CASE.

The statement of the case presented in the Petition is incomplete, and Respondent therefore presents the following additional summary.

Pursuant to the factoring agreement between Walter E. Heller & Co. and Bemporad Carpet Mills, Inc., Bemporad transferred and assigned its accounts receivable to Heller, who established an account on its books in Bemporad's name, which account was in the nature of a bank checking account except that only Heller could draw checks on it. As receivables were transferred by Bemporad to Heller, this account was credited in the face amount of the receivables, and from time to time Heller would debit the account to pay itself for interest charges, service charges, and for the payment of supplier accounts that Heller had guaranteed to and/or purchased from companies that were supplying raw materials to Bemporad. (See page 3 of Petition, including footnote.) A credit balance in this account represented a debt due from Heller to Bemporad for accounts receivable transferred to Heller but not paid for. The factoring agreement did not require that Heller pay any certain amount to Bemporad at any certain time as consideration for the assigned accounts receivable, and the procedure followed was for Heller to forward cash sums to Bemporad as requested and as available. Therefore, this account that Heller maintained for Bemporad was not strictly a reserve account. It was simply a general account containing all credits and all debits, representing the total receivables assigned to Heller by Bemporad, the total cash advancements to Bemporad, and all charges made by Heller against the account.

The first day of the four month period prior to bankruptcy was November 19, 1963. On that date Bemporad owed Heller over $168,000 for supplier invoices dated as

early as September. During the four month period Bemporad transferred $700,000 worth of receivables to Heller, but Heller only advanced $370,000 to Bemporad as present consideration therefor, leaving $330,000 worth of accounts not paid for. Because bankruptcy ensued at the end of this four month period, this $330,000 item represented either a fraudulent transfer under Section 67 (d) (2) (a) of the Bankruptcy Act or a preferential transfer under Section 60 (a) (1). Heller's records show that the $330,000 credit balance was appropriated by Heller for the purpose of satisfying the following indebtedness due from Bemporad to Heller, namely: the aforementioned $168,000 that was already due at the commencement of the four month period, and $119,000 in supplier accounts and interest charges that accrued during the four month period. The payments of antecedent debts represent preferential transfers, and all other payments represent fraudulent transfers.

Insofar as the preferential transfers are concerned, the trustee had the burden of proving the seven elements required by the Bankruptcy Act. (See **Mayo v. Pioneer Bank**, 270 F. 2d 823.) All of these elements, except insolvency and reasonable cause to believe insolvency, were stipulated at the pre-trial hearing and at the commencement of the trial itself as evidenced by the following excerpt from the record:

> "Mr. Morgan: Well, as far as the Trustee's burden of proof, the issues are insolvency, and reasonable cause.
>
> "The Court: That's right. Is there any dispute about that?
>
> "Mr. Gowen: No, sir."

During the trial Heller stipulated insolvency, and it also stipulated that it had reasonable cause from January 9, 1964 to the filing of the bankruptcy petition on March 18, 1964.

The District Court made a specific finding that Heller had reasonable cause during all of the four month period. (See A 27 of the Petition.)

The Fifth Circuit ruled that the evidence fully supported the District Court's finding that all of the elements of a voidable preference had been proved. (See A 2—first paragraph.) The Fifth Circuit then ruled against Heller's defense of set-off on two grounds: First, because Heller had received preferential transfers and was therefore barred by Section 68 (b) from using a set-off (A 6 and A 7); and, Second, because Heller was seeking to set-off against the Trustee the very payments that had been found to be voidable preferences. (A 12 of the Petition).

The statement of the case, as set forth on pages 2 through 5 of the Petition, presents a distorted picture of the transactions that gave rise to the trustee's claim.

The first distortion arises from the use, on page 3, of the words "purchased" and "purchase". Walter E. Heller & Co. purchased nothing. Some $330,000.00 worth of accounts receivable were transferred and assigned to Heller by the Bankrupt **during the four month period**, for which Heller gave no present consideration whatsoever. At least $287,000.00 was subsequently applied by Heller to pay itself for antecedent debts owing by the Bankrupt. The situation is analogous to that of **Commercial Credit Corp. v. Sorgel**, 274 F. 2d 449, 466 (5th Cir., 1960), wherein it was stated:

> "Howard transferred a substantial amount in accounts receivable to Commercial Credit after August 26, 1953, for which Commercial Credit did not advance any additional money. It cannot be said, therefore, that such accounts were 'purchased'." (See footnote on page A 2 of the Petition.)

The second distortion arises from the statements, on pages 4 and 5, that the Fifth Circuit held that the collec-

tions of the accounts and the set-offs against the factoring reserve constituted the voidable transfers. The Fifth Circuit did not so hold. The holding was that the preferential transfers consisted of the assignment and transfer of accounts receivable without present consideration, which accounts were thereafter applied to the payment of antecedent debts. In the "Order Denying Motion for Rehearing", the Fifth Circuit stated its holding as follows:

> "Bemporad delivered over to Heller some $700,000 in accounts during the four-month period preceding bankruptcy. $287,000 of these accounts was stipulated by Heller to have been applied on antecedent debts. Although Heller prefers to call the fund from which the $287,000 came a 'factoring reserve', it was made up of accounts receivable of Bemporad delivered over to Heller during the four month period. This delivery over or transfer, or whatever it might be called, when coupled with the application of accounts to antecedent debts, resulted in a transfer under § 60 a." (page A 11 of the Petition.)

The statement on page 4 of the Petition that "These set offs against the factoring reserve are the transfers which the Trustee alleged . . . to be voidable preferences", is not a true statement. In the complaint filed by the Trustee against Heller on October 8, 1964, it was alleged in the third and fourth paragraphs that "During the four month period . . . the bankrupt transferred to Walter E. Heller & Company . . . accounts receivable". It was therefore clear from the very beginning that the transfers sought to be avoided as preferences were those assignments of accounts receivable made by the Bankrupt to Heller during the four months prior to bankruptcy. Of course, the diversion by Heller of some $287,000 from the Bemporad account to itself in payment of antecedent debts was the culmination of the preferential transfers, but it was the

transfer and assignment from Bemporad to Heller during the four month period that actually constituted the voidable preferential transfers.

An additional distortion appears in the first full paragraph on page 5 of the Petition where it is stated that "Thus, in effect, the Fifth Circuit treated as decisive the time when the accounts were assigned." Nothing could be further from the truth. The Fifth Circuit opinion never mentioned the collection of the accounts, and the opinion makes it clear that it is the **assignment and transfer** of the accounts that created the preferential transfer (A 7 and A 11). If these transfers had not been subsequently applied to the payment of antecedent debts they would have been recoverable by the Trustee under Section 67 (d) as fraudulent transfers. Their application to the payment of antecedent debts simply served to categorize the transfers as preferential rather than fraudulent.

The ruling of the Fifth Circuit was:

1. "There is no question but that the evidence was substantial to support the finding that the trustee proved the elements necessary to establish the transfers as voidable under Section 60a" (page A 2 of Petition). (Even the District Court ruled that all of the essential elements of a voidable preference had been established. See pages A 6, A 13 and A 14, and A 1 where this fact is noted by the Fifth Circuit); and

2. Heller is not entitled to assert the right of set-off under Section 68 of the Bankruptcy Act because "by application of Section 68b(1), this advantage is available only to a creditor who has a claim that can meet the requirements of 57g of the Bankruptcy Act. . . . It follows that a creditor may not defend against the receipt of otherwise voidable preferences by asserting the right of set-off under Section 68 . . ."

IV. THE FIFTH CIRCUIT DECISION DOES NOT CONFLICT WITH ANY DECISION FROM ANY OTHER CIRCUIT.

1. The decision in the case at bar does not conflict with the Eighth Circuit case of **First Natl. Bank v. Julian**, 383 F. 2d 329, cited at pages 6 and 7 of the Petition. In the **Julian** case the Bank set off a checking account, designated as "Reserve Account", against a debt due to the Bank by the Bankrupt (p. 332). The Circuit Court held that this account was "a general checking account" (p. 337) and that "The account constituting a general deposit is subject to the Bank's right of set off . . ." (p. 338). There was no intimation by the Eighth Circuit that the checking account was made up of voidable preferential transfers, as is the situation in the Fifth Circuit case. The Fifth Circuit also recognizes the established rule of bankruptcy law set out in **Julian**, that a bank can set off a deposit received in good faith and in the regular course of business. **McKee v. Hood**, 312 F. 2d 394 (1) (5th Cir., 1963). In the **Julian** case, if the checking account had been created by voidable preferential transfers, the Eighth Circuit would necessarily have denied the right of set off, in line with the ruling in **Mechanics Bank v. Ernst**, 231 U. S. 60, 67, that "The so-called deposit . . . rightly was held to be a payment and a preference. A set-off properly was denied." There is no conflict at all between the Eighth Circuit and the Fifth Circuit on the question of a set-off under Section 68 of the Bankruptcy Act.

2. The Fifth Circuit decision is not in conflict with the Second Circuit decision in **Wolf v. Aero Factors Corp.**, 221 F. 2d 291, cited on page 6 of the Petition. On the contrary, the **Wolf** case is in support of the Trustee's position in the case at bar, involving a factual situation almost identical to that here involved. In **Wolf** the District Court had permitted the factor to set off against

certain non-preferential items, **but** the Court then held, at 126 F. Supp. 872, 882, as follows:

> "The word 'transfer' in the statute is used in its most comprehensive sense, and is intended to include every means and manner by which property can pass from the ownership or possession of a debtor to a creditor and by which the 'preference' forbidden by the Statute may be accomplished. **Pirie v. Chicago Title & Trust Co.**, 182 U. S. 438. . . . In the case at bar the bankrupt must have acquiesced in the deductions from the amounts due him and in the application of those sums to antecedent debts. Such conduct constituted a preferential transfer and the trustee is entitled to recover the $2,259.70 thus transferred."

The Second Circuit affirmed, and with regard to the items allowed as a set-off the Court held, at page 292:

> "Accordingly, **there being no preference**, the 'mutual debts or mutual credits' rule of Section 68 of the Bankruptcy Act, 11 U. S. C. A., § 108, was applicable" (emphasis added).

In the Fifth Circuit case under discussion, there was a preference, and therefore no set-off can be allowed.

3. The Fifth Circuit decision is not in conflict with the "implied holding" of the Tenth Circuit in **Porter v. Strevell-Paterson Finance Corp.**, cited on page 7 of the Petition. The **Porter** case did not involve any question of preferential transfers, and the Circuit Court did not deal with that point. The decision is totally irrelevant to the issues involved in the Fifth Circuit case.

4. The Fifth Circuit decision is not in conflict with the District Court decision in **Pasadena Investment Co. v. Pasadena Air Products, Inc.**, cited on page 7 of the Petition. Unlike the case at bar, the transfers in **Pasadena** were not voidable preferences. The Court there held at pages 134 and 135, as follows:

"Further, that such a preference may be avoided only if the transferee . . . had reasonable cause to believe that the debtor was insolvent. . . .

"Moreover, the evidence fails to establish that PIC had reasonable cause to believe that either PAP or Bradford were insolvent at the time of the factoring."

The Court there denied recovery to the Trustee because the Trustee failed to carry his burden of proving that the transfers were preferences as defined by Section 60 of the Bankruptcy Act. In the case at bar, all seven elements of a voidable preference were either proved by the Trustee or stipulated by Heller. (See A1 and A2 of the Petition.) Therefore, the ruling in **Pasadena** is irrelevant to the issues in the Fifth Circuit decision.

5. The Fifth Circuit decision follows the provisions of Section 60 of the Bankruptcy Act, and the case law based thereon, in holding that the transfer by the Bankrupt to Heller of $287,000 worth of accounts receivable without any present consideration, within four months of bankruptcy, when Heller knew that the bankrupt was insolvent, and which Heller used to pay itself for debts owed to it by the Bankrupt, constituted a voidable preferential transfer. No other correct legal ruling could have been made on the facts in this case. The Court then followed established bankruptcy law in denying Heller's defense of set-off.

V. HELLER IS NOT ENTITLED TO AN EXEMPTION FROM THE PROVISIONS OF SECTIONS 60 AND 68.

On page 11 of the Petition the statement is twice made that the Fifth Circuit held that the time when the accounts are collected determines the time of transfer. The Fifth Circuit did not so hold. The Court's opinion makes it crystal clear that it was the **transfer** of accounts during

the four month period that formed the basis for the Trustee's recovery. The issue regarding collection of the accounts was and is totally irrelevant, was never argued by the Trustee, and was never ruled on by either Court. The Fifth Circuit simply held that Heller did not give present consideration for the accounts so transferred to it and therefore it is liable to the Trustee under Section 60.

The plea is made, at pages 10 and 11 of the Petition, that the Fifth Circuit decision will adversely affect the factoring business and that therefore Heller should not be required to return the voidable preferences to the Trustee.

Heller's plea for exemption from the provisions of the Bankruptcy Act can best be answered by a quotation from the decision in **Corn Exchange Natl. Bank & Trust Co. v. Klauder**, 318 U. S. 434, 437 (1943):

> "Such a construction is capable of harsh results, and it is said that it will seriously hamper the business of 'non-notification financing', of which the present case is an instance. This business is of large magnitude and it is said to be of particular benefit to small and struggling borrowers. Such consequences may, as petitioners argue, be serious, but we find nothing in Congressional policy which warrants taking this case out of the letter of the [Bankruptcy] Act."

The dire prediction made at page 11 of the Petition, that the Fifth Circuit decision will severely limit the availability of factoring, is pure conjecture. Moreover, it asserts a conclusion that is not warranted by past events. As early as 1942 the Second Circuit ruled that a trustee in bankruptcy could recover from a factor the value of accounts receivable assigned by the bankrupt within the

four months preceding bankruptcy, where same were shown to be voidable preferences. See **Swetman v. Edmund Wright Ginsberg Corp.**, 128 F. 2d 1, 4 (cert. denied, 317 U. S. 647, 63 S. Ct. 42). The Southern District of New York, in the heart of the factoring industry, has held accordingly in **In Re Ace Fruit & Produce Co.**, 49 F. Supp. 986 (7) (1943), and in **Wolf v. Aero Factors Corp.**, 126 F. Supp. 872 (22) (1954). In spite of these decisions, and in spite of the fact that the Bankruptcy Act itself grants no exemption to factors from the effects of Sections 60 and 67, the factoring industry has prospered. The Fifth Circuit decision does not change existing law, nor does it introduce any new legal principle. It merely follows the plain language of the Bankruptcy Act. It is therefore difficult to accept Heller's prediction of disaster if this decision is left in effect.

VI. THE ISSUE OF SET-OFF IS A FALSE ISSUE.

Heller, at page 5 of its Petition, refers to Section 68 (a) of the Bankruptcy Act and thereby seeks to create the impression that it has a claim that entitles it to a set-off under that Section. The record shows, however, that Heller does not have, and never has had, a claim that was within the purview of Section 68. For that reason Heller's claim of set-off is a false issue in this case.

Heller's position, as set forth in its brief filed with the Fifth Circuit, is that during the four month period Bemporad owed Heller a large sum of money, and when Bemporad delivered the aforementioned accounts receivable to Heller there was thereby created a debt from Heller to Bemporad, and Heller then set off the one debt against the other. That position is factually correct, but it is not a Section 68 set-off. This is the type of transaction that was condemned by the Seventh Circuit in **Froehling v. Amer. Trust & Savings Bank**, 177 Fed. 194

(2) (1910), where it was held that a purchaser of property from a bankrupt within the four month period cannot set off the purchase price against a debt due to him by the bankrupt.

Moreover, it is well settled that a creditor cannot set off, against the trustee's claim for recovery of preferences, the very debts that the preferences satisfied. **Walker v. Wilkinson**, 296 Fed. 850 (4), 852 (5th Cir., 1924). In the case at bar, Heller satisfied $287,000 worth of indebtedness, and it is this same $287,000 that is being asserted as a set-off against the trustee's claim.

In addition, Section 68 speaks only of "mutual debts". It is established law that the statutory liability of a preferred creditor to surrender the preference to the trustee in bankruptcy is not a "debt" within the meaning of Section 68. **United States v. Roth**, 164 F. 2d 575 (6, 7) (2nd Cir., 1948); **In Re American Creameries**, 90 F. Supp. 618 (3), 622 (S. D., Tex., 1950); and **In Re Majestic Radio & Television Corp.**, 227 F. 2d 152 (5) (7th Cir., 1955).

The effect on the bankrupt estate is the same, whether Heller simply took the assigned accounts and applied them in payment of antecedent debts, or whether it first credited the value of the receivables to the Bemporad account and then debited the account, utilizing what it calls a "set-off". In either event Heller gets $287,000 for nothing, and the bankrupt estate sustains a loss of $287,000.

Applicable in either event is the ruling in **National Bank of Newport v. Nat. Herkimer County Bank**, 255 U. S. 178, 184, 32 S. Ct. 633, 635 (1912), that it is the effect of the transfer that determines the preference, and not the mere form or method pursued.

VII. CONCLUSION.

The decision of the Fifth Circuit being legally sound, and the matter not falling within the purview of Rule 19 of the Supreme Court Rules, the Respondent respectfully requests the Court to deny the Petition.

.....

OSCAR M. SMITH,
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P. O. Box 29,
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Certificate of Service.

I do hereby certify that I have this day mailed in a properly stamped envelope a copy of the foregoing Brief to Charles L. Gowen, Trust Company of Georgia Building, Atlanta, Georgia 30303, attorney for Petitioner.

This 19th day of March, 1968.

.....

Oscar M. Smith,
Attorney for Respondent.